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SUBJECT: LABOR MARKET REFORMS COULD HELP TURKISH  
UNEMPLOYMENT PROBLEM

REF: ANKARA 6410

11. (SBU) Summary: Turkey has relatively low wage levels in relation to comparator countries yet strong growth has not made much of a dent in high unemployment. Rapid growth in the working-age population contributes to low employment rates, but so do labor market problems including high severance payments, rigid rules impeding temporary employment, and high employment taxes. The IMF, World Bank and OECD have all called for reforms in these areas although the IMF has been hesitant to reduce payroll taxes to avoid worsening the Social Security deficit. New data suggests the fiscal cost may be worth paying because lower payroll taxes would bring more employment into the formal sector. The Government is reportedly considering these reforms but may not take them on until after next year's elections. Labor reforms are just one of several areas of structural reform the Government will need to tackle if wants to deepen and sustain its economic success. If the next Government is a coalition, it will be much harder. End Summary.

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Turkey's Persistent Unemployment Problem  
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12. (SBU) Despite four years (2002 through 2005) of 7.5% real GDP growth, Turkey's unemployment rate remains stubbornly high. Recently released data for August 2006 show an unemployment rate of 9.1%, slightly better than the 9.4% recorded in August 2005, but still high. Most economists agree that the unemployment rate is not that meaningful in Turkey and understates the extent of the problem, since such a large share of the working-age population is either underemployed or has given up looking for work. A more meaningful indicator is the employment rate, which has crept up slightly, from 43.7% of the working-age population in 2004 to 45% in August, 2006. It is still, however, far below that of comparator countries: the EU-15, for example have an average employment rate of 65%.

13. (SBU) Turkish Government officials point to the large number of jobs created by Turkey's growth: roughly one million last year, but this job growth fails to make a dent in the unemployment rate because of the demographics: Turkey's high birth rates in the 1980's have meant a continued flooding of the work force with new entrants. In addition, substantial rural-urban migration has meant people formerly counted as employed in the agricultural sector -- even though most of them worked on inefficient small-scale farms -- are now in the urban work force. The latter

phenomenon helps explain why employment rates for women in Turkey are less than half of employment rates for women in western Europe (EU-15). The women were considered employed when they were on the farm, but tend to stay home more than men when Turkish families move to the city.

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Despite Low Wage Costs  
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¶4. (SBU) The price of labor is not the problem. Despite the strength of the lira in recent years, Turkish wage costs continue to be low in relation to comparator countries. The World Bank has analyzed Turkish wage costs in terms of cost per value-added and found Turkish wages compare quite favorably to other OECD countries. By this measure, for example, Turkish wages were only two-thirds of Mexico's, suggesting substantial room for both wage and employment growth. Our sense from talking to Turkish subsidiaries of multinational companies is that the Turkish labor force is attractive to employers: reasonably priced, educated and with relatively low absentee rates. This also helps to explain the continued growth of Turkish manufacturing exports despite the strong lira: i.e. Turkish labor costs in manufacturing remain competitive.

¶5. (SBU) Although average wages are relatively low by international standards, the legal minimum wage is relatively high. According to the OECD, the minimum wage in Turkey is substantially higher than in Poland, Slovakia, Estonia, Bulgaria or Romania. The ratio of the minimum wage to the average wage in the formal sector was higher in Turkey (48%) than in any other OECD country. The OECD report points out that the relatively high minimum wage magnifies the negative impact of the labor tax wedge on employment in the formal

sector, as the wage costs of low-skilled workers often exceed their productivity levels.

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Rigid Labor Markets  
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¶6. (SBU) The IMF and World Bank have been pointing out for some time that some features of Turkey's labor market are exacerbating the unemployment problem and should be reformed. The OECD, in its recent review of the Turkish economy, made similar points. Turkey is tied with Portugal as having the highest severance payments -- one month pay for each year worked -- in the OECD. This prohibitive cost is one deterrent to firms hiring, in case they ever have to cut staff. Turkey's rules on temporary employment also hinder labor market flexibility: according to the ECD report, Turkey's temporary employment rules are the most rigid in the OECD by a significant margin. Firms employing more than 50 workers are also required to hire 6% of their workforce from "socially assisted" groups (ex-convicts, handicapped people, victims of terrorist attacks).

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High Payroll Taxes  
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¶7. (SBU) Turkey's high payroll taxes also discourage hiring. Many analysts and local pundits have picked up on Turkey having the highest tax "wedge" -- i.e. the difference between what an employee receives and an employer's total payment (including taxes) -- in the OECD. In fact, State Planning Organization officials have explained to us that the truth is a bit more nuanced: calculations of the tax wedge depend on family size and what is included in the calculation. By one calculation, for an employee with a family of four, Turkey has the highest tax wedge in the OECD. But this nuance doesn't change the main point: that payroll taxes are relatively high in Turkey and act as a deterrent to hiring.

¶8. (SBU) The OECD and the World Bank have been recommending some reduction in the tax wedge to spur employment. The IMF,

on the other hand, fears that a reduction in payroll taxes will exacerbate the outsized deficit in the social security system, since most payroll taxes are really social security taxes. World Bank officials told us that with Economy Minister Babacan's support, they have been able to access company-level data at the Turkish National Statistics Agency that suggests a high elasticity of labor demand in Turkey. In other words, the Bank officials believe the data suggest that reductions in payroll taxes will have a big impact in terms of employers leaving the informal economy and beginning to pay their social security taxes. This, in turn means that the fiscal cost of a payroll tax cut will be partially recouped from higher participation rates.

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Comment  
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19. (SBU) The Government seems to be catching on to the importance of attacking these labor market problems: the World Bank officials told us the Government is considering a package of labor reforms but might opt to wait until after next year's elections. Labor market reforms are one of several areas of reforms that the Government will need to address if it wants to sustain and deepen its four-year track record of economic success. It will need to tackle a "second generation" of structural reforms if it wants to sustain high per capita growth rates and permanently end the Turkish economy's vulnerability to boom-and-bust cycles. Labor market reforms -- if they produce more jobs -- will also help provide the political support to sustain economic reform. These kinds of reforms will be politically difficult for the current government but if the November 2007 elections produce a coalition government, it will be much harder, if not impossible.

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